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No. 97-147

In the
Supreme Court of the United States
October Term, 1997

ATLANTIC MUTUAL INSURANCE CO. AND INCLUDIBLE SUBSIDIARIES,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari
To The United States Court of Appeals
For The Third Circuit

BRIEF FOR PETITIONER

George R. Abramowitz
Counsel of Record
Dennis L. Allen
M. Kristan Rizzolo
LeBoeuf, Lamb, Greene & MacRae, L.L.P.
1875 Connecticut Avenue, N.W.
Washington, D.C. 20009-5728
(202) 986-8000
John S. Breckinridge, Jr.
James H. Kenworthy
LeBoeuf, Lamb, Greene & MacRae, L.L.P.
125 West 55th Street
New York, New York 10019
(212) 424-8000

Counsel for Petitioner

LSP

QUESTION PRESENTED

Whether petitioner engaged in "reserve strengthening" in 1986 within the meaning of section 1023(e)(3)(B) of the Tax Reform Act of 1986, as determined by respondent under a Treasury regulation that petitioner contends is invalid.

PARTIES TO THE PROCEEDING

All the parties are named in the caption.

STATEMENT PURSUANT TO RULE 29.6

There are no parent or subsidiary companies to be listed under the provisions of Rule 29.6.

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OPINIONS BELOW

The opinion of the Third Circuit is reported at 111 F.3d 1056 and is set forth in its entirety in the Appendix to the Petition for Writ of Certiorari at A-1. The opinion of the Tax Court, reversed by the Third Circuit, is unofficially reported at 71 T.C.M. (CCH) 2154 and is set forth in its entirety in the Appendix to the Petition for Writ of Certiorari at A-26.

JURISDICTION

The decision below was issued by the Third Circuit on April 24, 1997 and judgment was entered on that date. Petitioner herein, Atlantic Mutual Insurance Company (hereinafter "Atlantic") and Includible Subsidiaries, did not

file a petition for rehearing in the Third Circuit. In accordance with 28 U.S.C. § 2101(c), a Petition for Writ of Certiorari was filed on July 22, 1997 and was granted on October 20, 1997. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant portions of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1023, 100 Stat. 2085, 2404 (1986); of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 216, 98 Stat. 494, 758 (1984); and of Treas. Reg. § 1.846-3(c) (1992), are set forth in the Appendix to the Petition for Writ of Certiorari at A-48, A-50, and A-52, respectively.

STATEMENT OF THE CASE

A. *The Statute and the Treasury Department Regulations.*

1. *The Statute.*

The question in this case involves the meaning of the term "reserve strengthening" in section 1023(e)(3)(B) of the Tax Reform Act of 1986 (the "1986 Act").

In 1986, Congress changed the way in which insurance companies compute reserves for unpaid losses and loss adjustment expenses arising under insurance and reinsurance policies ("loss reserves") for federal income tax purposes. Before the 1986 Act, insurers were allowed to

reduce income each year by the amount of their "losses incurred," which were defined as losses paid plus (minus) the increase (decrease) during the year in undiscounted loss reserves. Section 1023 of the 1986 Act required loss reserves to be discounted to present value for purposes of determining losses incurred beginning in 1987. Under section 1023 of the 1986 Act, for purposes of computing the annual change in its loss reserves for its 1987 tax year, an insurer was required to discount both year-end 1987 loss reserves and year-end 1986 loss reserves.

In the absence of a special transition provision, the difference between the undiscounted and discounted year-end 1986 loss reserves would have been includible in taxable income. I.R.C. §§ 481, 807(f) (1986). Section 1023(e) of the 1986 Act, however, provided a "fresh start" under which that difference was permanently excluded from taxable income for all purposes of the Internal Revenue Code of 1986 (the "Code").

Because Congress was concerned about the potential for abuse of the "fresh start" provision, Congress provided that the amount of the discount on any loss reserve increase in 1986 attributable to "reserve strengthening" would be eliminated from the "fresh start" and treated as an increase in 1987 taxable income. To that effect, section 1023(e)(3)(B) of the 1986 Act provides as follows:

> RESERVE STRENGTHENING IN YEARS AFTER 1985. -- [The fresh start] shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as

occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

Section 1023(e)(3) of the 1986 Act was patterned after virtually identical "fresh start" and "reserve strengthening" rules contained in section 216(b) of the Deficit Reduction Act of 1984 (the "1984 Act"), which contained provisions changing the way in which insurance companies compute life insurance reserves ("life reserves") for federal income tax purposes. *See infra* pp. 19-20.

2. *The Regulations.*

On September 4, 1992, the Treasury Department issued a sweeping regulatory interpretation of the term "reserve strengthening" for purposes of section 1023 of the 1986 Act. T.D. 8433, 1992-2 C.B. 146. According to those interpretive regulations, the amount of "reserve strengthening" under the 1986 Act is the amount (as computed under paragraphs (2) and (3) of section 1.846-3(c)) that is determined to have been "added" to a loss reserve during 1986.[1] For loss reserves at year-end 1986 in respect of losses that occurred in 1985 and prior years ("pre-1986 accident years"), those regulations include a so-called

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[1] For purposes of section 1.846-3(c) of the Treasury Department regulations, a loss reserve is defined as the aggregate of the unpaid loss estimates for losses incurred in an accident year of a line of business. An "accident year" is the year of the occurrence of an event specified in an insurance policy that triggers the insurer's liability for resulting losses. I.R.C. § 846(f)(1) (1986). A "line of business" refers to a group of insurance policies covering similar risks and for which a separate category exists for reporting loss payment patterns. I.R.C. § 846(f)(4) (1986).

"mechanical test" for "reserve strengthening." Under that test, if a loss reserve at December 31, 1986 for a pre-1986 accident year exceeded the amount of the loss reserve at December 31, 1985 less the amounts paid in 1986 on that loss reserve, the excess automatically is deemed "reserve strengthening" up to the amount of the 1986 loss reserve.[2] The excess is so deemed under the mechanical test even when there is, in fact, no increase in the amount of the 1986 loss reserve over the amount of the 1985 loss reserve.[3] Treas. Reg. § 1.846-3(c)(1) and (3) (hereinafter sometimes referred to as the "regulation").

In short, the regulation sweeps into the definition of "reserve strengthening" *all* 1986 increases in a loss reserve in respect of pre-1986 accident years, plus certain increases in pre-1986 losses incurred even when a loss reserve did not increase. The regulation thus applies the "reserve strengthening" definition without regard to whether such

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[2] The regulation provides two narrow exceptions from this rule, neither of which is applicable in this case. Treas. Reg. § 1.846-3(c)(3)(ii).

[3] The Tax Court's opinion in *Western National Mutual Ins. Co. v. Commissioner* contains an example in which the regulation would find "reserve strengthening" when there has been no increase in a loss reserve. 102 T.C. 338, 349 n.8 (1994). *See infra* pp. 46-47. For simplicity, Atlantic hereinafter sometimes describes the effect of the mechanical test in the regulation as including "any increase" or "all increases" in loss reserves for pre-1986 accident years, even though the regulation treats as "reserve strengthening" some situations in which a loss reserve was not in fact increased.

increases resulted from changes in the insurer's reserving assumptions or methodologies.[4]

B. *Western National Mutual Ins. Co. v. Commissioner.*

The first case that addressed the definition of the term "reserve strengthening" as used in section 1023 of the 1986 Act was *Western National Mutual Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), *aff'd*, 65 F.3d 90 (8th Cir. 1995), In *Western National*, the taxpayer, which had not changed its assumptions or methodologies in calculating its year-end 1986 loss reserves, challenged the validity of the regulation regarding "reserve strengthening." The taxpayer introduced into evidence the reports of two highly qualified property and casualty insurance experts regarding the meaning of the term "reserve strengthening" as used in the property and casualty insurance business. In general, those experts testified that the characteristics of "reserve strengthening" include changes in assumptions or methodologies. Respondent did not submit any expert testimony. Respondent claimed that congressional intent, as expressed in the Conference Committee report accompanying the 1986 Act (the "Conference Report") supported the regulation.

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[4] While the regulation defines "reserve strengthening" in an all-encompassing manner for pre-1986 accident year losses, section 1.846-3(c)(2) of the Treasury Department regulations limits the amount of "reserve strengthening" with respect to the 1986 accident year to the portion of a loss reserve for the 1986 accident year attributable to *changes in assumptions* that were used to determine loss reserves for the same line of business for the 1985 accident year.

The Tax Court concluded that, if Congress intended to exclude *all* 1986 additions to loss reserves from the application of the "fresh start" provision, as provided in the regulation, Congress would have included in the statute that straightforward rule, rather than a term of art used in an unconditional manner. 102 T.C. at 355. The Tax Court further concluded that Congress intended the term "reserve strengthening" in the 1986 Act to be interpreted in a manner consistent with the undisputed meaning of the same term in the 1984 Act (which was consistent with its insurance industry meaning). *Id.* at 354, 360. The Tax Court therefore determined that the regulation was contrary to the unambiguous meaning of the term "reserve strengthening" as used in the statute. As a consequence, the Tax Court held the regulation to be "invalid to the extent that it defined all additions to reserves as reserve strengthening." *Id.* at 361.

On appeal, the United States Court of Appeals for the Eighth Circuit affirmed the holding of the Tax Court. The court stated that the provision in question was not drafted with the lay reader in mind and that there was "no statutory basis for the Commissioner's present attempt to make reserve strengthening mean one thing in the life insurance industry but another in the property and casualty industry." *Western National*, 65 F.3d at 93. The court went on to say that "[e]ven if there were no property and casualty industry definition of reserve strengthening, . . . we see nothing that would prohibit Congress from appropriating the life insurance standard and applying it to a property and casualty provision of the Code." *Id.* The Eighth Circuit held that Congress intended to deny "fresh start" only to increases in loss reserves caused by changes in assumptions or

methodologies and that "the regulation cannot be sustained." *Id.* at 93-94.

C. *The Facts of This Case.*

This case was submitted to the Tax Court as a fully stipulated case under Rule 122 of the Tax Court Rules of Practice and Procedure. Aside from the content of expert reports, the parties agreed to all of the relevant facts.

Atlantic, a property and casualty insurance company, is taxable as an insurance company under Parts II and III of Subchapter L of Chapter 1 of Subtitle A ("Subchapter L") of the Code. Atlantic is the common parent of affiliated corporations which filed a consolidated return. (Jt. App. at 23-24, Stip. ¶¶ 1, 3.)[5] Centennial Insurance Co. ("Centennial"), a property and casualty insurer wholly owned by Atlantic, was included in Atlantic's consolidated return. (Jt. App. at 24, Stip. ¶ 5.) (Hereinafter, references to Atlantic include Centennial where appropriate and the Atlantic affiliated group where appropriate.) For regulatory and tax purposes, Atlantic was required to estimate, as of the end of each year, the amount of losses and loss adjustment expenses it ultimately would pay on losses that had occurred by the end of the year. (Jt. App. at 29, Stip. ¶ 14.) Those loss reserves were reasonable in amount at the end of 1985 and at the end of 1986. (Jt. App. at 38, Stip. ¶ 39.)

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[5] The Joint Appendix filed with this brief is cited herein as Jt. App. at ___. The Stipulations of Fact filed with the Tax Court are included in the Joint Appendix at pp. 22-48 and are cited herein as Stip. ¶ ___.

On a hindsight basis, Atlantic's aggregate 1985 and 1986 loss reserves were inadequate to discharge the liabilities covered by such reserves. Its aggregate 1986 loss reserves were more inadequate than its aggregate 1985 loss reserves. (Jt. App. at 32-33, Stip. ¶ 24.) Atlantic did not increase its loss reserves for 1985 and prior accident years included in its aggregate loss reserves at year-end 1986 for tax-motivated reasons. (Jt. App. at 39, Stip. ¶ 41.) Atlantic computed its December 31, 1986 loss reserves using the same assumptions and methodologies used in determining its loss reserves as of December 31, 1985. (Jt. App. at 37-38, Stip. ¶ 38.) In its tax return for 1987, Atlantic included the entire difference between its undiscounted and discounted loss reserves at December 31, 1986 in the "fresh start" allowed by the 1986 Act. (Jt. App. at 24-25, Stip. ¶ 6.)

Using the mechanical test of the regulation, respondent determined that a portion of Atlantic's year-end 1986 loss reserves for pre-1986 accident years resulted from "reserve strengthening." That amount was determined in general by subtracting from Atlantic's year-end 1986 loss reserves for pre-1986 accident years the amount of its loss reserves at year-end 1985 less payments made in respect of such loss reserves during 1986. (Jt. App. at 24-27, Stip. ¶¶ 6, 7, 8, 9.) Based on that determination, respondent issued a statutory notice of deficiency for 1987 to Atlantic.

D. *Proceedings Below.*

Atlantic petitioned the Tax Court for redetermination of the 1987 deficiency pursuant to sections 6213(a) and 7442 of the Code.

Atlantic entered into evidence the reports of Irene Bass and James MacGinnitie, two experts who testified in *Western National*. Irene Bass opined that, in the property and casualty insurance business, "reserve strengthening" involves changes in assumptions or methodologies used to compute loss reserves that result in a material change in the level of adequacy of those reserves. (Jt. App. at 73.) James MacGinnitie concurred with Irene Bass. (Jt. App. at 98.)

Respondent entered into evidence the reports and rebuttal reports of two experts indicating that the term "reserve strengthening" in property and casualty insurance is used in more than one manner. Both of respondent's experts acknowledged that the term is used in property and casualty insurance to mean increases in reserves involving changes in assumptions or methodologies, as Atlantic's experts stated. (Jt. App. at 184, 200, 202.) However, respondent's experts each expressed different views regarding other uses of the term.

Finding the case before it factually indistinguishable from *Western National*, the Tax Court held that Atlantic had not engaged in "reserve strengthening" within the meaning of section 1023(e)(3)(B) of the 1986 Act. 71 T.C.M. (CCH) 2154, 2159-60 (1996). Respondent appealed the Tax Court's decision to the Court of Appeals for the Third Circuit. In a decision entered April 24, 1997, the Third Circuit reversed the decision of the Tax Court, and in so doing, it expressly refused to follow the decision of the Eighth Circuit in *Western National* holding that the meaning of "reserve strengthening" in the 1986 Act is plain. 111 F.3d 1056, 1061 n.7 (1997).

SUMMARY OF ARGUMENT

This case involves the validity of a Treasury regulation that interprets the term "reserve strengthening" as used in the 1986 Act. Atlantic contends that the regulation does not properly interpret the statutory term.

The overriding consideration in the interpretation of any statutory term is its plain meaning. The plain meaning of "reserve strengthening" in the 1986 Act can be determined by looking to its established meaning in insurance tax precedents and the undisputed meaning of the term as used in the 1984 Act.

For decades, the term "reserve strengthening" in insurance taxation consistently has been used in Treasury Department regulations, Internal Revenue Service rulings, and judicial decisions to mean increases in reserves involving changes in assumptions or methodologies. It is undisputed that the definition of "reserve strengthening" as used in the 1984 Act was consistent with the established insurance tax meaning. The identity between the language and context of the "reserve strengthening" provisions of the 1984 Act and of the 1986 Act leads to the conclusion that the plain meaning of the term "reserve strengthening" in the 1986 Act is the established tax meaning of the term, *i.e.*, reserve increases involving changes in assumptions or methodologies.

Contrary to the holding of the Eighth Circuit in *Western National*, the Third Circuit concluded that the term "reserve strengthening" did not have a plain meaning, and that, based on the legislative history, the regulation was a

valid interpretation of the statutory language. In reaching its conclusion, the Third Circuit relied on the lack of a statutory definition of "reserve strengthening," the expert testimony, a perceived difference between life reserves and loss reserves, and a change in the statutory language to show that "reserve strengthening" does not have a plain meaning. Each of the Third Circuit's reasons is without merit.

It is clear from this Court's precedents that the term "reserve strengthening" in the 1986 Act takes meaning from the established use of the term and the structure and context of the statute, making a statutory definition unnecessary to finding the plain meaning of the term. Further, the expert testimony in this case cannot negate that plain meaning in insurance taxation. Moreover, the Third Circuit's assertions regarding the differences between life reserves and loss reserves are misplaced. The Third Circuit's assertions regarding the absence of assumptions and methodologies in computing loss reserves makes no sense. Even the government's experts recognized that changes in assumptions or methodologies used in computing loss reserves occur and can give rise to "reserve strengthening." Finally, the Third Circuit incorrectly interpreted a difference in the statutory language between the 1984 Act and the 1986 Act to establish the absence of a plain meaning of "reserve strengthening" in the 1986 Act. The statutory difference in question had no impact whatever on the general definition of the term "reserve strengthening."

Once the Third Circuit's missteps are recognized, it is clear that the plain meaning of "reserve strengthening" in the 1986 Act is increases in reserves involving changes in assumptions or methodologies. Thus, the regulation is

invalid to the extent it leads to the result that Atlantic, which did not change its assumptions or methodologies in establishing its 1986 loss reserves, engaged in "reserve strengthening."

Further, the Third Circuit failed to recognize that, even if "reserve strengthening" as used in the 1986 Act did not have a plain meaning, the regulation would be invalid because it does not limit "reserve strengthening" to "artificial" increases in reserves as described in the legislative history of the 1986 Act and because it reaches even beyond respondent's explanation of congressional intent.

ARGUMENT

I.
The regulation cannot be valid if it is contrary to the plain meaning of the term "reserve strengthening" as Congress used it in section 1023(e)(3)(B) of the 1986 Act.

In its decision below, the Third Circuit stated that its inquiry into the validity of the Treasury Department's interpretation of the term "reserve strengthening" as used in the 1986 Act was controlled by the principles of *Chevron U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984). In articulating the *Chevron* principles, the court noted: "Initially, we must determine whether the meaning of 'reserve strengthening' is clear from the plain language of section 1023(e)(3)(B)." *Atlantic Mutual*, 111 F.3d at 1059. If the Treasury Department's interpretation

of the term conflicts with that plain language, the interpretation is invalid. *See, e.g., Brown v. Gardner*, 513 U.S. ___, 115 S. Ct. 552, 556 (1994).

This Court has held repeatedly that if the plain meaning of a term can be discerned from an analysis of the text of the statute, the analysis is complete. *See, e.g., id.*; *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 475 (1992); *Demarest v. Manspeaker*, 498 U.S. 184, 190 (1991). To determine the plain meaning of statutory language, this Court has looked to the text of the statute, the structure of the statutory scheme as a whole, the context of the statute (including the text of related statutes and the established usage of statutory terms), and canons of statutory construction. *See, e.g., Commissioner v. Lundy*, 516 U.S. ___, 116 S. Ct. 647, 655 (1996); *Gardner*, 513 U.S. at ___, 115 S. Ct. at 555; *Commissioner v. Keystone Consolidated Industries, Inc.*, 508 U.S. 152, 159 (1993).

As the Third Circuit implicitly recognized in this case, only if the statute is not plain should legislative history be relevant to the inquiry. *Atlantic Mutual*, 111 F.3d at 1062. Legislative history should not be relevant to the determination of a statute's plain meaning because "it is the statute, and not the Committee Report, which is the authoritative expression of the law." *City of Chicago v. Environmental Defense Fund*, 511 U.S. 328, 337 (1994); *see also Davis v. Michigan Dept. of Treasury*, 489 U.S. 803, 808-09 n.3 (1988) (citing *United Air Lines, Inc. v. McMann*, 434 U.S. 192, 199 (1977)).

As shown below, the plain meaning of the term "reserve strengthening" in section 1023(e)(3)(B) of the 1986

Act can be determined from an interpretation of the statutory text in accordance with the established meaning of the term and Congress' use of the same term in virtually identical circumstances in the 1984 Act. *See Lundy*, 516 U.S. at ___, 116 S. Ct. at 655; *Gardner*, 513 U.S. at ___, 115 S. Ct. at 555; *Keystone*, 508 U.S. at 158-59; *see also Rowan Companies, Inc. v. United States*, 452 U.S. 247 (1981).

II.
The plain meaning of the term "reserve strengthening" as used in the 1986 Act can be discerned from the term's established meaning and the prior use of the identical term in an analogous statute.

A. The term "reserve strengthening" consistently has been used in insurance tax precedents to mean increases in reserves involving changes in assumptions or methodologies.

In Treasury Department regulations, Internal Revenue Service rulings, and judicial decisions involving the taxation of insurance companies, both property and casualty and life, the term "reserve strengthening" has been used, without exception, to mean those reserve increases involving changes in assumptions or methodologies.

The term "reserve strengthening" as used in the insurance tax law has its roots in the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112 (1959) (the "1959 Act"). Before the 1959 Act, life insurance companies were taxed only on net investment income. The 1959 Act expanded the tax base to include

underwriting income. In determining underwriting income under the 1959 Act, life insurance companies were allowed a deduction for annual increases in insurance policy reserves.[6] I.R.C. §§ 809(b) and (d)(2) and 810(b) and (c) (1954).

Congress recognized, however, that if a company strengthened its insurance policy reserves, which were now tax deductible, the company could distort its reserve deduction in computing its underwriting income. Congress enacted section 810(d)[7] (the predecessor to section 807(f) of the 1986 Code) to spread over time the tax deduction for increases in reserves attributable to "reserve strengthening." *See National Life and Accident Ins. Co.*, 524 F.2d 559, 560 (6th Cir. 1975). In implementing the provisions of section 810(d), the Treasury Department regulations provide extensive rules that differentiate between the treatment of normal annual reserve increases, which are deductible in their entirety in the year of increase, and increases attributable to changes in the basis of computing reserves (*i.e.*, "reserve strengthening"). *See, e.g.*, Treas. Reg.

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[6] For this purpose, tax deductible insurance policy reserves included (1) life reserves, (2) unearned premium reserves and loss reserves, (3) policy obligations under insurance and annuity contracts not involving life, health, or accident contingencies, (4) certain dividend accumulations under insurance and annuity contracts, (5) advance premiums, and (6) certain retired lives and premium stabilization reserves under group insurance contracts. I.R.C. § 810(c) (1954).

[7] All section references in this Section II. A. are to the Internal Revenue Code of 1954, unless otherwise indicated.

§ 1.810-3(b) *Examples 1 and 2* (1961); Treas. Reg. § 1.810-3(f) *Example 3* (1961).[8]

The Internal Revenue Service, in applying the above statutory and regulatory provisions over the years, uniformly has used the term "reserve strengthening" to mean increases in reserves involving changes in assumptions or methodologies. *E.g.*, Rev. Rul. 79-395, 1979-2 C.B. 263 (involving a life insurance company that strengthened certain of its life reserves by changing its reserve computation method from the preliminary term basis to the net level premium basis); Rev. Rul. 70-192, 1970-1 C.B. 153 (involving a life insurance company that strengthened its reserves by changing to the assumption that death benefits are paid at the middle of the policy year rather than the end of the policy year); Rev. Rul. 65-240, 1965-2 C.B. 236 (involving a property and casualty insurance company that strengthened its life reserves on guaranteed renewable health policies by changing the basis of computing such reserves from the preliminary term basis to the net level premium

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[8] The Treasury Department regulations use the terms "change in basis" and "reserve strengthening" interchangeably to mean reserve increases involving changes in assumptions or methodologies. *See, e.g.*, Treas. Reg. § 1.810-3(a). As the Tax Court in *Western National* stated:

> The phrase "change in the basis of computing such reserves" also appeared in sec. 818(c) [of the 1954 Internal Revenue Code], where "basis" has been interpreted to mean "method". *Reserve Life Ins. Co. v. United States*, 229 Ct. Cl. 529, 640 F.2d 368, 377 (1981).

102 T.C. at 353, n. 14.

basis); and Rev. Rul. 65-233, 1965-2 C.B. 228 (holding that "reserve strengthening" took place in 1959 when the insurance company took "all necessary steps to change the reserve basis for group annuity reserves and to initiate a program for strengthening reserves on individual contracts" prior to December 31, 1959).

The judicial precedents under Subchapter L of the Code also interpret the term "reserve strengthening" in a uniform manner to mean reserve increases involving changes in assumptions or methodologies. In *National Life and Accident Ins. Co. v. United States*, 381 F. Supp. 1034 (M.D. Tenn. 1974), *aff'd* 524 F.2d 559 (6th Cir. 1975), for example, the insurance company changed its assumption regarding the date when death benefits are deemed paid. The District Court analyzed sections 809 and 810 and recognized a distinction between normal annual reserve increases and "reserve strengthening" increases. *Id.* at 1038. The Sixth Circuit cited with approval the comprehensive opinion written by the District Court. 524 F.2d at 560. *See also, e.g., Jefferson Standard Life Ins. Co. v. United States*, 272 F. Supp. 97 (M.D.N.C. 1967), *aff'd in part, rev'd in part, and remanded*, 408 F.2d 842 (4th Cir. 1969).

The long list of precedents shows that the term "reserve strengthening" consistently has been used for insurance tax purposes to mean increases in reserves involving changes in assumptions or methodologies. Those precedents involve both life insurance companies and property and casualty insurance companies. They also apply to all the reserve items listed in section 810(c) (now section 807(c) of the 1986 Code), including life reserves, loss

reserves, and the other reserve items enumerated in that section.

B. Respondent agrees that the term "reserve strengthening" was used in the 1984 Act to mean increases in reserves involving changes in assumptions or methodologies in accord with its established meaning in the insurance tax precedents.

The 1984 Act significantly changed the way in which insurance companies compute life reserves for federal income tax purposes. As in the case of the 1986 Act change in the computation of loss reserves, the 1984 Act change in the computation of life reserves resulted in a reduction in the amount of reserves for most insurers affected by the change. 1984 Act §§ 201-231. Absent special statutory relief, insurance companies affected by the 1984 Act change in the computation of life reserves would have been required to include in income the difference between their life reserves as of the end of 1983 computed on the pre-existing method and on the method prescribed in the 1984 Act.

To provide relief from the adverse effect of the new reserve computation provisions contained in the 1984 Act, Congress provided a "fresh start" transition rule under which any decrease in an insurer's life reserves that resulted from the amendments made by the 1984 Act would not be treated as a change requiring an adjustment to taxable income.

Recognizing that the "fresh start" provision was subject to abuse, Congress included in the 1984 Act a "reserve strengthening" exception to the "fresh start" relief.

Thus, any "reserve strengthening" "reported for federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984," was excluded from the "fresh start."

There is no question that Congress used the term "reserve strengthening" in the 1984 Act in a manner consistent with its well established insurance tax meaning. In fact, respondent never felt the need to issue any regulatory interpretation of the term "reserve strengthening" in the 1984 Act. Moreover, respondent acknowledged, both in this case and in the *Western National* case, that the term "reserve strengthening" as used in the 1984 Act had the same meaning that, without exception, has been ascribed to it in the insurance tax precedents, *i.e.*, increases in reserves involving changes in assumptions or methodologies. *Atlantic Mutual*, 71 T.C.M. (CCH) at 2159; *Western National*, 102 T.C. at 353.

C. The "reserve strengthening" provision of the 1986 Act is in all relevant respects the same as the "reserve strengthening" provision of the 1984 Act.

1. The general structure and content of the provisions of the 1984 Act and of the 1986 Act.

Both the 1984 Act and the 1986 Act contained provisions that significantly changed the way in which insurers compute their insurance policy reserves. 1984 Act § 211(a); 1986 Act §§ 1023(a)-(d). Both changes involved adjustments which generally resulted in decreases to the

affected reserves for federal income tax purposes.[9] There is an identity between the overall structure and content of the 1984 Act and the 1986 Act reserve computation changes, and, in particular, the use within that structure and content of the identical term "reserve strengthening."

The 1984 Act amended the Internal Revenue Code to provide for a change in the way in which life reserves are computed for federal income tax purposes; the 1986 Act amended the Internal Revenue Code to provide for a change in the way in which loss reserves are computed for federal income tax purposes. Section 216 of the 1984 Act and section 1023(e) of the 1986 Act each addresses three collateral matters with respect to the respective changes in reserve computation rules: (1) each specifies that the respective reserve computation changes apply to total reserves as of the beginning of the first year to which the new rules applied and provides a concomitant transitional rule; (2) each allows a "fresh start" with respect to the transitional rule; and (3) each provides a "reserve strengthening" exception to the "fresh start." Those provisions are addressed in detail below.

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[9] Each set of changes applied equally to companies taxed as life insurance companies under Part I of Subchapter L of the Code and other insurance companies taxed under Part II of Subchapter L. (*See infra* note 11 and accompanying text for a discussion of the relationship between Part I and Part II of Subchapter L.) Sections 211(b)(9) and 216(a)(2) applied the 1984 Act reserve computation changes to life reserves included in a property and casualty insurer's reserves under section 832(b)(4) of the 1954 Code for the first taxable year after 1983. Similarly, sections 1023(b) and (e)(2)(B) applied the 1986 Act reserve computation changes to a life insurer's loss reserves under section 807(c)(2) of the Code for the first taxable year after 1986.

2. The transitional rules.

In enacting new insurance policy reserve computation rules in the 1984 Act and in the 1986 Act, Congress had to decide whether to apply the new rules just to newly established reserves (*i.e.*, for policies issued or losses incurred during the year of change and thereafter) or to existing reserves in addition to newly established reserves. In each case, Congress made the new reserve computation rules applicable to both existing reserves and newly established reserves. As a consequence, a rule was necessary to provide a transition from the old to the new rules for existing reserves. In the case of each statute, Congress adopted comparable transition rules:

The 1984 Act. The transitional rule of the 1984 Act provides that the life reserves carried over from the last preceding taxable year to the first taxable year in which the new reserve computation rules applied must be computed using the new reserve computation rules. 1984 Act § 216(a). The general effect of that transitional rule was to reduce the December 31, 1983 reserve balances carried over to the beginning of 1984 by the amount of the difference between the year-end 1983 life reserves computed under the old and new rules.

The 1986 Act. The transitional rule of the 1986 Act provides that the loss reserves carried over from the last preceding taxable year to the first taxable year in which the new reserve computation rules applied must be computed using the new reserve discounting computation rules. 1986 Act § 1023(e)(2). The

general effect of that transitional rule was to reduce the December 31, 1986 reserve balances carried over to the beginning of 1987 by the amount of the difference between the year-end 1986 loss reserves computed on the old undiscounted basis and the new discounted basis.

3. The "fresh start" adjustments.

In the normal course of insurance company accounting for federal income tax purposes, the amount of the reduction in the reserve balances carried over to the new year under the transitional rules of the 1984 Act and the 1986 Act would have been included in income. I.R.C. §§ 481 and 807(f) (1986); I.R.C. § 810(d) (1954). As a policy matter, Congress chose not to require, under either the 1984 Act or the 1986 Act, the income adjustments that would have flowed from the reserve computation changes mandated by the two statutes. The relief from such income adjustments is referred to as the "fresh start." In the case of each statute, Congress adopted comparable "fresh start" provisions:

The 1984 Act. In general, the "fresh start" adjustment of the 1984 Act eliminated the income inclusion by providing that any change in the basis of computing reserves between the end of 1983 and the beginning of 1984 resulting from the 1984 Act was not to be treated as a change in method of accounting (or of computing reserves) for federal income tax purposes. 1984 Act § 216(b)(1).

The 1986 Act. In general, the "fresh start" adjustment of the 1986 Act eliminated the income

inclusion by providing that any change in the amount of loss reserves between the end of 1986 and the beginning of 1987 resulting from the 1986 Act was not to be taken into account for federal income tax purposes. 1986 Act § 1023(e)(3)(A).

4. The "reserve strengthening" exception.

In the case of both the 1984 Act and the 1986 Act, there was a potential for distortion of the "fresh start" provision. Specifically, if an insurance company artificially increased its reserves before the new reserve computation rules took effect, the amount of the "fresh start" would have increased. To prevent such abuse, Congress restricted the application of the "fresh start" under both the 1984 Act and the 1986 Act. Neither the 1984 Act nor the 1986 Act denied the "fresh start" relief *per se* to all reserve increases in the year in which the "fresh start" relief was announced. Instead, the limitation on "fresh start" for reserve increases applied in a more limited way. In the case of each statute, Congress adopted the same general "reserve strengthening" limitation on the "fresh start":

> **The 1984 Act.** In general, the 1984 Act disallowed the "fresh start" with respect to any "reserve strengthening" reported for federal income tax purposes after September 27, 1983 for the 1983 taxable year. 1984 Act § 216(b)(3)(A).
>
> **The 1986 Act.** In general, the 1986 Act disallowed the "fresh start" with respect to "reserve strengthening" reported for federal income tax

> purposes for the 1986 taxable year. 1986 Act § 1023(e)(3)(B).

Based on a comparison of the structure and content of the 1984 Act and the 1986 Act, it is apparent that the term "reserve strengthening" in the 1986 Act was used in the context of the very same type of statutory provision and served the very same purpose as the term "reserve strengthening" in the 1984 Act.

D. The general concept of the insurance policy reserves which were the subject of the "reserve strengthening" provisions of the 1984 Act and of the 1986 Act is the same.

The classic purpose of insurance, whether life insurance or property and casualty insurance, is to pool the probable cost of the same types of risks of loss over a large number of policyholders. *See Helvering v. LeGierse*, 312 U.S. 531 (1941). In line with their loss pooling function, insurance companies issue policies that promise to pay future claims if contingencies specified in the policies occur. In order to provide for the payment of policyholder claims under its policies, an insurance company recognizes a "reserve" liability on its balance sheet for the future payment of claims. National Association of Insurance Commissioners, *Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies* 10-1 (rev. ed. 1996); National Association of Insurance Commissioners, *Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies* 10-1 (rev. ed. 1994).

The principal reserves of a life insurance company generally are life reserves and the principal reserves of a property and casualty insurance company generally are loss reserves. A.M. Best Company, *Best's Aggregates and Averages: Life-Health United States* 2 (1997 ed.); A.M. Best Company, *Best's Aggregates and Averages: Property-Casualty United States* 2 (1997 ed.) . The main difference between the insurance policy reserves of life insurance companies and of property and casualty insurance companies is that life reserves are established for the future payment of future policy claims, and loss reserves are established for the future payment of existing policy claims. Treas. Reg. § 1.832-4(b) (1992); *United States v. Atlas Life Ins. Co.*, 381 U.S. 233, 237 n.3 (1965); *Modern Home Life Ins. Co. v. Commissioner*, 54 T.C. 935, 939 (1970). In general terms, however, the insurance policy reserves of all insurers serve a similar purpose. As the Tax Court observed in *Western National*:

> In the insurance industry a policy reserve represents a liability; i.e., it represents an obligation to the policyholders. Historically, reserves have been described in [property and casualty] insurance literature as estimated liabilities for losses and loss adjustment expenses. To some extent, loss reserves are estimates extrapolated from past trends, patterns, averages, and inferences and predictions as to the future. Accordingly, "The reserve simply operates as a charge on so much of an insurance company's assets as must be maintained in order for the company to be able to meet its future commitments under the policies it has issued." The general concept of

> reserves is the same for life and [property and casualty] insurance companies.

102 T.C. at 350-351 (footnote and citations omitted).

As demonstrated by the foregoing, the "reserve strengthening" provisions of the 1984 Act and of the 1986 Act applied to insurance policy reserves that are the same in general concept.

E. The term "reserve strengthening" is used in property and casualty insurance to refer to an increase in loss reserves involving a change in assumptions or methodologies.

While respondent's experts offered testimony indicating that there are other uses in property and casualty insurance for the term "reserve strengthening," the only use of the term "reserve strengthening" that each expert agreed applies in property and casualty insurance is reserve increases involving changes in assumptions or methodologies. That one definition is consistent with the use of the term "reserve strengthening" in the 1984 Act and with the established insurance tax meaning of the term.

In her expert report, Irene Bass opined that, in the property and casualty insurance business, "reserve strengthening" involves changes in assumptions or methodologies used to compute loss reserves that result in a material change in the level of adequacy of those reserves. (Jt. App. at 74.) In his expert report, James MacGinnitie concurred with the opinion of Irene Bass. (Jt. App. at 98.) Regarding the definition provided by Bass and MacGinnitie,

one of respondent's experts, Raymond Nichols, admitted that it is not wrong, and that it is "understandable to actuaries and useful in some applications." (Jt. App. at 184, 200.) Nichols also opined that Bass' definition is "legitimate and useful" and "clear and well-reasoned." (Jt. App. at 195.) Respondent's other expert, Ruth Salzmann, also agreed that "these criteria [*i.e.*, changes in assumptions or methodologies] produce reserve strengthening . . . ." (Jt. App. at 202.)

F. The plain meaning of "reserve strengthening" in section 1023(e)(3)(B) of the 1986 Act is an increase in loss reserves involving a change in assumptions or methodologies.

As demonstrated above, the plain meaning of the term "reserve strengthening" as used in section 1023(e)(3)(B) of the 1986 Act is an increase in loss reserves involving a change in assumptions or methodologies. That plain meaning can be discerned from the term's longstanding use in insurance tax law and from the term's prior use in a virtually identical provision in the 1984 Act. *See, e.g.*, *Lundy*, 516 U.S. at __, 116 S. Ct. at 655; *Gardner*, 513 U.S. __, 115 S. Ct. at 555.

To suggest Congress would have used in a new manner a term with a decades old meaning in insurance tax law, and one that it had used just two years before in a virtually identical insurance tax provision, is to presume Congress either was deliberately misleading or was careless in drafting an amendment relating to a subchapter of the Code which it has so carefully crafted in the past. Either explanation is "implausible in light of the intricate attention

to detail displayed throughout Subchapter L." *Colonial American Life Ins. Co. v. Commissioner*, 491 U.S. 244, 260 (1989); *see also National Life and Accident Ins. Co.*, 381 F. Supp. at 1034 (observing that "Congress was fastidious, not sloppy, in the quality of draftsmanship exhibited in Subchapter L, so as to make decipherable a rather technical portion of the Code.").

This is particularly true when Congress easily could have used, on the face of the 1986 Act, such plain language as "all additions" or "all increases" if it intended to adopt an exception to the "fresh start" consistent with the mechanical test adopted in the regulation rather than one based on "reserve strengthening" as that term is used in insurance tax law. As noted by the Tax Court in *Western National*, "Had Congress intended to exclude any addition to the reserves from the application of the fresh-start provisions as respondent contends, the statute could have included that language." 102 T.C. at 355.

In fact, the meaning of the term "reserve strengthening" is so ingrained in insurance tax law that any effort to redefine the term in the integrated world of Subchapter L inevitably leads to anomalous consequences. For example, as noted above, the 1986 Act loss reserve discounting rules applied to companies taxed as life insurance companies as well as companies taxed as property and casualty insurance companies. *Supra* note 9. At the time that the 1986 Act became law, a life insurance company's change in basis in computing loss reserves was already subject to the "reserve strengthening" provisions of section 807(f) of the 1954 Code (formerly section 810(d) of the 1954 Code). I.R.C. § 807(c) (1954). Moreover, at that

time, the Treasury Department regulations applicable under section 807(f) used the term "reserve strengthening" to mean those increases in reserves involving changes in assumptions or methodologies. Unless the term "reserve strengthening" as used in section 1023 of the 1986 Act is read to mean reserve increases involving changes in assumptions or methodologies (i.e., its established tax meaning), the 1986 loss reserve increases for pre-1986 accident year losses of life insurance companies would be subject to two *different* "reserve strengthening" definitions.

III.
Atlantic did not change its assumptions or methodologies, and the regulation is invalid to the extent it resulted in a determination that Atlantic engaged in "reserve strengthening."

As demonstrated above, the term "reserve strengthening" as used in the 1986 Act has a plain meaning that involves a change in assumptions or methodologies used in determining loss reserves. Respondent stipulated that Atlantic did not change its assumptions or methodologies used to establish its loss reserves at December 31, 1986 from those used to establish its loss reserves at December 31, 1985. (Jt. App. at 37-38, Stip ¶ 38.) By applying the mechanical test of the regulation, respondent determined that Atlantic had made "net additions" to its loss reserves at December 31, 1986 for pre-1986 accident years and that those "net additions" constituted "reserve strengthening." The regulation must be held invalid to the extent it resulted in a determination that Atlantic engaged in "reserve strengthening," because Atlantic did not change the

assumptions or methodologies used in determining its year-end 1986 loss reserves.

IV.
The Third Circuit erred in upholding the validity of the regulation.

A. The Third Circuit erred in concluding that the term "reserve strengthening" did not have a plain meaning in the 1986 Act.

Before reaching to ambiguous legislative history of section 1023(e)(3)(B) to seek a meaning for the term "reserve strengthening," the Third Circuit concluded that there was no plain meaning for the term to be derived from the statute. The Third Circuit listed four reasons for its conclusion, none of which has any merit.

1. The lack of a statutory definition of the term "reserve strengthening."

The Third Circuit began its analysis by noting, "Clearly absent from the text of the statute is any explanation of the meaning of the term 'reserve strengthening.'" 111 F.3d at 1060. The Third Circuit subsequently cited the lack of a statutory definition of the term as one of the reasons for its conclusion "that the meaning of the term 'reserve strengthening' is ambiguous." *Id.* at 1062.

The lack of a statutory definition does not by itself make a term ambiguous. If that were the case, most statutory terms would be considered ambiguous because few statutory terms are defined in the statute. This Court has held that the

structure and context of a statute can give meaning to a statutory term (without the need to turn to the legislative history to find a meaning for the term). *See, e.g.*, cases cited *supra* Part I. The long history of use of the term "reserve strengthening" in insurance tax law and its prior use in virtually identical circumstances in the 1984 Act provided the term with a plain meaning in the 1986 Act. Congress had no more reason to provide an explicit definition of the term in the 1986 Act than it did in the 1984 Act, and the absence of a statutory definition in the 1986 Act therefore does not create ambiguity.

2. The expert testimony.

The Third Circuit pointed to the expert testimony as proof that the term "reserve strengthening" as used in the 1986 Act does not have a plain meaning. 111 F.3d at 1060-62. However, given the structure and context of the 1986 Act and the longstanding tax definition of the term "reserve strengthening," there is ultimately no need for experts to validate the meaning of the statutory term.[10] As the Eighth Circuit stated in *Western National*, "Even if there were no property and casualty industry definition of reserve strengthening . . . , we see nothing that would prohibit

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[10] Nor should expert testimony be used to validate a regulation that such testimony does not clearly support. Three of the experts (including one of respondent's experts) agreed that the mechanical test for "reserve strengthening" contained in the regulation is not a correct usage of the term. (Jt. App. at 85, 98-99, 172.) In fact, not only would respondent's expert Ruth Salzmann agree that the regulation is not a correct usage of the term, she apparently would conclude that Atlantic *weakened* its reserves because its aggregate 1986 loss reserves were more inadequate than its aggregate 1985 loss reserves. (Jt. App. at 168.)

Congress from appropriating the life insurance standard and applying it to a property and casualty provision of the Code." 65 F.3d at 93.

The Third Circuit noted, "Indeed, the Tax Court in *Western National* commented that the opinions and testimony of the numerous expert witnesses failed to establish a 'universal and precise definition of reserve strengthening.'" 111 F.3d at 1060-61 (citation omitted). The implication of this comment is that even the Tax Court recognized that the expert testimony demonstrates that the term "reserve strengthening" has no plain meaning in the 1986 Act. However, what the Tax Court concluded in *Western National* was that the term "reserve strengthening" as used in the 1986 Act has a plain meaning consistent with the meaning of the term as used in the 1984 Act. 102 T.C. at 354. With respect to the experts, the court simply observed that the expert testimony "provided sufficient guidance to enable our recognition of the conceptual elements involved in industry jargon." *Western National*, 102 T.C. at 351 n.10.

The Third Circuit also ignored the fact that the expert reports *are not inconsistent* with the long-standing tax definition of the term "reserve strengthening" that is tied to changes in assumptions or methodologies. The Third Circuit's footnote describing the experts highlighted some differences in the definition of "reserve strengthening" provided by the experts, but it failed to note that each of the experts agreed that property and casualty insurance actuaries *do* use the term to mean increases in reserves attributable to changes in assumptions or methodologies. *See supra* Part II.E.

Thus, the Third Circuit was wrong to conclude that the expert reports create ambiguity. Rather, the experts confirm the plain meaning of the term "reserve strengthening" in the 1986 Act derived from the established insurance tax meaning and prior usage of the term.

3. The comparison of life reserves and loss reserves.

The Third Circuit erroneously dismissed the application of the established tax definition of "reserve strengthening" in the context of the 1986 Act by noting distinctions between life reserves and loss reserves. The Third Circuit criticized "[t]he Tax Court's reliance on cases, revenue rulings and legislation involving life insurance reserves" as being "misplaced." 111 F.3d at 1061. In fact, it is the Third Circuit's conclusion that is misplaced.

a. Subchapter L in general.

Initially, the Third Circuit asserted, "For federal income tax purposes, life insurance companies and P & C insurers are taxed in entirely separate manners. Gross income as well as loss reserves are computed on different bases and assumptions." *Id.* This assertion is both irrelevant and incorrect.

There is no reason why any perceived difference in the scheme for taxation of life insurance companies and of property and casualty insurance companies would have any relevance to the interpretation of the term "reserve strengthening." Reserves are clearly common to the taxation of both types of insurance companies, and the general

concepts associated with reserves, such as "reserve strengthening," are common to both. *See supra* Part II.D.

As important, the Third Circuit's assertion regarding the "entirely separate manners" of taxation of life insurance companies and of property and casualty insurance companies is off base. Both life insurance companies and property and casualty insurance companies are taxed under Subchapter L of the Code, and although life insurance companies and property and casualty insurance companies generally are taxed under separate parts of Subchapter L, the basic taxing scheme of the two types of companies is, in all relevant respects, the same. In fact, it should be noted that insurance companies may be licensed to write various types of insurance business and that the test for determining whether an insurer that writes life and non-life business is subject to tax as a life or property and casualty insurer is based on the amount of its life reserves in relation to its total reserves, including loss reserves.[11] I.R.C. § 816(a) (1986).

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[11] Subchapter L of the Code actually is an integrated system for taxing all insurance companies. Each part of Subchapter L incorporates provisions from the other part. Thus, life insurance companies taxed under Part I take into account losses incurred -- a concept found in Part II of Subchapter L -- in computing taxable income, and insurers taxed under Part II take into account changes in any life reserves they hold -- a concept found in Part I of Subchapter L. I.R.C. §§ 805(a), 807(c), and 832(b)(4) (1986). In addition, Subchapter L includes a Part III, Provisions of General Application, which contains provisions that apply *both* to life insurance companies and to property and casualty insurance companies. I.R.C. §§ 841-848 (1986). Significantly, section 846 of the Code, to which the "reserve strengthening" provision in the 1986 Act relates, is included in Part III of Subchapter L.

b. The nature of loss reserves.

Also incorrect was the Third Circuit's conclusion that the definition of "reserve strengthening" as used in the 1984 Act could not logically apply in the property and casualty context because property and casualty insurance loss reserving practices are significantly different from reserving practices for life reserves.[12] The court's statements regarding those perceived differences demonstrate a lack of understanding of loss reserving, and the court's conclusion regarding the applicability of the "reserve strengthening" rule is in any event a nonsequitur. The Third Circuit concluded:

> We find it illogical to apply the life insurance definition of reserve strengthening to P & C insurers -- whose reserves are not predicated upon the same actuarial assumptions. If we did so apply it, arguably there would never be any reserve strengthening in the P & C area since interest rates, mortality assumptions and methodologies are not underlying components of the P & C loss reserves.

111 F.3d at 1061. Even assuming the Third Circuit was correct in its contention that interest rates and mortality assumptions are never used in property and casualty loss

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[12] In this connection, the Third Circuit overlooked the fact that loss reserves of companies taxed as life insurance companies already were subject to the established "reserve strengthening" definition. *See supra* pp. 29-30.

reserving,[13] the court was wrong to imply that interest rates and mortality assumptions are the only actuarial assumptions that can have any relevance for purposes of "reserve strengthening."[14] The Third Circuit seemed to recognize that loss reserves are computed based on actuarial assumptions. (The Third Circuit's recognition that actuarial assumptions are used to compute loss reserves is confirmed by section 1.846-3(c)(2) of the Treasury Department regulations which is applicable to the 1986 accident year.) The court simply noted that the assumptions are different from those used to compute life reserves. 111 F.3d at 1061. Of course, to the extent that the Third Circuit recognized that there are assumptions underlying loss reserves, its assertion that the application of the established insurance tax law definition to loss reserves would never produce "reserve strengthening" is self-contradictory.

The Third Circuit went even further afield when it asserted that methodologies are not part of loss reserving. The court described loss reserving as focused on claims

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[13] In fact, there are some property and casualty loss reserves that are based in part on interest rate and mortality assumptions. For example, workers' compensation tabular indemnity reserves are "calculated using discounts determined with reference to actuarial tables which incorporate *interest* and contingencies such as *mortality*, remarriage, inflation, or recovery from disability applied to a reasonably determined payment stream." National Association of Insurance Commissioners, *Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies* at 10-3 (emphasis added).

[14] As noted *supra* Part II.E., the one use of the term "reserve strengthening" agreed to by all of the experts in property and casualty insurance is increases in loss reserves involving changes in assumptions or methodologies.

experience and judgments of individual claims adjusters and concluded that "methodologies are not underlying components of the P & C loss reserves." *Id.* It should be noted that the Third Circuit's focus on claims and the judgment of claims adjusters has relevance only in the context of case reserves. That description of reserving does not address reserves for incurred but not reported losses and other formula-based reserves. Moreover, two of the experts in this case, including one of the government experts, clearly describe the extensive use of methodologies in setting loss reserves. (Jt. App. at 58-60, 146-50.)

4. The deleted sentence.

The Third Circuit determined that the commonality of structure and language between the 1984 Act and the 1986 Act does not lead to the conclusion that the term "reserve strengthening" should be interpreted consistently. Fundamental to the court's reasoning was that a sentence that was included in the 1984 Act was not included in the 1986 Act. Specifically, the Third Circuit stated:

> [W]e find that the reserve strengthening provision in [the 1984 Act] differs from the provision in [the 1986 Act] . . . . The 1984 statute specifically links reserve strengthening by life insurance companies to changes in the reserve practice used on the most recent annual financial statement. A similar limitation was contained in the Senate amendment to section 1023(e)(3)(B) but was intentionally eliminated by the Conference Committee.

111 F.3d at 1062. Relying on *Russello v. United States*, 464 U.S. 16 (1983), the Third Circuit then adopted the presumption that Congress intended to change the meaning of the term "reserve strengthening" in the 1986 Act by deleting the sentence that contained the limitation. The premise for the Third Circuit's conclusion -- that there was statutory language in the 1984 Act that defined the term "reserve strengthening" -- is flatly wrong.

The sentence in the 1984 Act on which the Third Circuit's conclusion was based is as follows:

> [The reserve strengthening exception] shall not apply to the computation of reserves on any contract issued if such computation employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983, for the type of contract with respect to which such reserves are set up.

1984 Act § 216(b)(3)(A). The Third Circuit assumed that the above sentence infused the term "reserve strengthening" in the sentence it followed in the statute with a meaning that was tied to changes in assumptions or methodologies, and that by removing the above sentence, the Conference Committee in 1986 changed the definition of the term "reserve strengthening." *Atlantic Mutual*, 111 F.3d at 1062. The Third Circuit failed to give adequate recognition to the established meaning of the term "reserve strengthening." Moreover, it failed to properly interpret the sentence it cited.

As demonstrated at length *supra* Part II.A., the term "reserve strengthening" had an established meaning in

insurance tax law when Congress used it in the 1984 Act. In fact, the House version of the 1984 Act (which preceded the Senate version) contained the "fresh start" rule and the "reserve strengthening" exception, but *not* the sentence in question regarding prior reserve practices. 130 Cong. Rec. H8914 (daily ed. April 11, 1984). This by itself suggests that the sentence regarding reserve practices was not inserted by the Senate to provide a baseline definition of the term "reserve strengthening." Further, a careful reading of the sentence itself actually indicates that its specific purpose was to provide a special rule for contracts that were newly "issued" in 1983.

That *limited* purpose is in fact confirmed by the Senate version of the House Bill, which first included the sentence in question. That version was structured a bit differently than the final 1984 Act. It listed certain exclusions from the general "reserve strengthening" exception in separate paragraphs with *titles*. The title and precise sentence here in question are as follows:

> EXCEPTION FOR COMPUTATION OF RESERVES ON *NEW* CONTRACTS IN CUSTOMARY MANNER. Subparagraph (A)(iii) [the "reserve strengthening" exception] shall not apply to the computation of reserves on any contract issued if such computation employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983, for the type of contract with respect to which such reserves are set up.

H.R. 4170 (as reported by the Senate Finance Committee), 98th Cong., 2d Sess. § 216(b)(3)(C) (1984) (emphasis added). There is no indication that the deletion of the title in the final version of the 1984 Act was intended to change the Senate "reserve strengthening" rule or the exception therefrom for newly issued contracts contained in the unchanged sentence. It should be clear, therefore, that the sentence for *new* contracts in the 1984 Act cannot properly be alleged to provide a general definition to the term "reserve strengthening" in the statute. Instead, its only purpose was to provide a limited special rule to exclude from the "reserve strengthening" exception to the "fresh start" rule any reserves on new 1983 contracts that were calculated in the same manner as the reserves at year-end 1982 on the same types of contracts.

When the Senate Finance Committee drafted its "reserve strengthening" exception to the 1986 "fresh start" rule, it followed almost precisely the pattern of the "reserve strengthening" language in the 1984 Act, including a sentence immediately after the "reserve strengthening" exception that read: "The preceding sentence [the "reserve strengthening" exception] shall not apply to the computation of reserves on any contract if such computation employs the reserve practice used for purposes of the most recent annual financial statement filed on or before March 1, 1986, for the type of contract with respect to which reserves are set up." H.R. 3838 (as reported by the Senate Finance Committee), 99th Cong., 2d Sess. § 1022(e) (1986). The deletion of that sentence from the actual 1986 Act is unexplained. Possibly the deletion related to the change in the Conference Bill from a date in March 1986 to year-end 1985 as the trigger date for the "reserve strengthening" exception. Or possibly the

Conference Committee may have recognized that the sentence was difficult to apply to the reserves subject to the 1986 "fresh start" rule which were calculated with respect to policy *claims*, and were not calculated with respect to "contracts." *See supra* p. 26. In any event, for the reasons noted above, the deletion of the limited special rule could not be relevant to any analysis of the plain meaning of the term "reserve strengthening."

B. The Third Circuit erred in concluding that the regulation implements the intent of Congress in a reasonable manner.

Even if the Third Circuit were correct in concluding that the term "reserve strengthening" has no plain meaning and the legislative history is relevant to the analysis, the court was wrong to conclude that the legislative history in this case supports the mechanical test of "reserve strengthening" adopted in the regulation.

In reviewing the legislative history, the Third Circuit focused on a part of one sentence in the Conference Committee report, and a statement of one Senator inserted in the Congressional Record after enactment, as "evidence" for its conclusion that the Conference Committee provided a definition of "reserve strengthening" that was more expansive than that of the Senate Committee and which could be harmonized with the regulation. 111 F.3d at 1063-64. It seems self-evident that a statement of an individual Senator, which was unreviewed by anyone, cannot establish the intent of Congress. With respect to the Conference Report, the Third Circuit quoted the following language to support its labeling of the Conference

Committee's description of "reserve strengthening" as "all inclusive" -- "reserve strengthening" shall be considered to include "'all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year) . . . .' H.R. Conf. Rep. No. 99-841." 111 F.3d at 1065. Yet, a review of the *entire* legislative history can only lead to the conclusion drawn by the Eighth Circuit and the Tax Court in *Western National* -- it "'provides no persuasive rationale for interpreting the statutory term "reserve strengthening" in a manner different from industry usage.'" 65 F.3d at 93 (quoting 102 T.C. at 355).

As discussed above, the change in the statutory language between the Senate version of the provision and the Conference version had no impact on the established meaning of "reserve strengthening." *See infra* Part IV.A.4. The Conference Report states, "The conference agreement modifies the Senate amendment with respect to the *treatment* of "reserve strengthening" under the "fresh start" income forgiveness provision." H.R. Rep. No. 99-841, at II-367 (1986) reprinted in 1986 U.S.C.C.A.N. 4075, 4455 (emphasis added). In the two sentences immediately following the sentence indicating that a "modification" was made, the Conference Report explains that the excluded "reserve strengthening" was any "reserve strengthening" taking place in taxable years beginning after December 31, 1985, rather than "reserve strengthening" reported after March 1, 1986, as the Senate bill had provided. Thus, the "modification" highlighted in the Conference Report is linked directly with the change in the date when the "reserve strengthening" exception to the "fresh start" took effect. Contrary to the Third Circuit's opinion in this case, the

legislative history never says that the conference agreement "expanded" the *definition* of "reserve strengthening."

Further, after describing the change to the date when the "reserve strengthening" exception was to take effect, the Conference Report lists reserve additions that the "reserve strengthening" provision "is considered to include" in juxtaposition with a sentence stating that Congress intended the "reserve strengthening" provision to prevent taxpayers from "artificially" increasing loss reserves and therefore the amount of income forgiven under the "fresh start." H.R. Rep. No. 99-841, at II-367. The Third Circuit's interpretation of the legislative history -- that it proves Congress intended the term "reserve strengthening" to mean any increase during 1986 in pre-1986 accident year loss reserves -- creates an apparent contradiction between those two sentences. The Third Circuit dismissed the resulting contradiction between the two sentences by speculating that the Conference Report used the term "'artificial' in a general sense, to refer to any increases in the reserves other than those resulting from the difference attributed to the discounting of reserves." 111 F.3d at 1065.

The Third Circuit's explanation of the term "artificial" makes no sense. The 1986 Act excluded from the "fresh start" any "reserve strengthening" *during 1986*. Even assuming that the discounting of loss reserves could somehow result in an increase in reserves (a result that intuitively seems unobtainable), Congress' reference to "artificial" reserve increases could not possibly have been intended to differentiate increases due to discounting from all other increases, because insurance companies were not

required to discount their loss reserves for tax purposes during *1986*. The discounting rules took effect in 1987.

The reference to "artificial" increases in the legislative history must have been intended to differentiate unusual loss reserve increases from normal loss reserve increases as the Tax Court believed.[15] 102 T.C. at 356. The mechanical test of the regulation goes far beyond any notion of preventing only artificial loss reserve increases. Indeed, it captures *all* increases to net reserves (and more). *See supra* p. 5. The Third Circuit therefore was wrong to conclude that the regulation is consistent with the Conference Report and that the regulation can be harmonized with Congress' intent.

C. The Third Circuit erred in failing to hold that the regulation is invalid because it reaches beyond even respondent's explanation of congressional intent.

Even if respondent were correct in interpreting "reserve strengthening" to mean any increase in net reserves,

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[15] Although the Conference Report language is ambiguous, the Tax Court's alignment of the two sentences is far more plausible than that of the Third Circuit. The original "reserve strengthening" rule under section 810(d) of the 1954 Code provided an exception to the general rule that annual reserve increases are currently deductible in order to prevent distortions in income caused by unusual or non-periodic reserve increases involving changes in assumptions or methodologies. *See National Life and Accident Ins. Co.*, 524 F.2d at 560. It is entirely logical for Congress to have turned to a "reserve strengthening" exception, with its established insurance tax meaning, to prevent "artificial" increases in reserves from distorting income forgiven under the 1986 Act "fresh start."

the regulation is invalid because it produces absurd and inequitable results that go far beyond the notion of "any increase." Respondent has admitted that the mechanical test in the regulation can result in erroneous computations, but respondent refused to take into account specific examples of inaccuracies furnished by affected insurers. *See* T.D. 8433, 1992-2 C.B. at 148. In the notice of proposed rule making accompanying the regulations, respondent explained:

> Because the test is applied to each unpaid loss reserve, rather than to each separate loss, the test does not take into account the fact that a particular loss payment may exceed, or be less than, the initial estimate of the amount of the loss for which the payment was made. This may result in a failure to include, or an erroneous inclusion of, certain amounts in the computation of reserve strengthening for a particular reserve. For most unpaid loss reserves, however, any potential inaccuracies are likely to offset each other in the aggregate.

FI-139-86, 1991-2 C.B. 946, 947. There simply is no support for the statement that the inaccuracies caused by the mechanical test required by the regulation would tend to offset each other in the aggregate.

1. The absurd results.

As noted by the Tax Court in *Western National*, the mechanical test contained in the regulation produces absurd results. 102 T.C. at 349 n.8, 361. The Tax Court provided an example of such absurd results which demonstrates that the regulation clearly is over broad. *Id.* at 349 n.8.

The example assumes four loss reserves of $500 each included in case reserves by a property and casualty insurer at December 31, 1985. During 1986, two of the case reserves were closed by payments of $750 each. The other two case reserves remained open at December 31, 1986 with no change in the $500 reserve amount. Pursuant to the mechanical test, the Commissioner would find "reserve strengthening" of $500, *i.e.*, 1986 loss reserves, $1,000, less the net of 1985 loss reserves, $2,000, and 1986 payments, $1,500, equals $500. Respondent would disallow as "fresh start" the discount on $500 of the remaining loss reserve under the guise that there was $500 of "reserve strengthening."

Clearly, there were no additions to either loss reserve remaining at December 31, 1986. Since the December 31, 1986 loss reserves included no amounts for the two paid losses, there was no "fresh start" in respect of the two closed claims. Nevertheless, the payments caused the mechanical test to produce "reserve strengthening." Were it not for the respondent's mechanical test contained in the regulation, the closures of the case reserves by payment in 1986 would have had no effect on losses incurred for the taxable year 1987. Because of the mechanical test, however, 1987 losses incurred will be reduced for a discount on a deemed amount of reserve increase which was not included in any reserve for a loss at December 31, 1986 and which, therefore, could not and did not increase the insurer's "fresh start."

Other examples of the absurd results produced by the mechanical test in the regulation are found in the report of Irene Bass, one of petitioner's experts. (Jt. App. at 79, 86.)

Thus, in certain circumstances, the mechanical test of the regulation creates "reserve strengthening" only as the result of claim payments, even if there is *no increase* in reserves affecting the "fresh start." Clearly, respondent has promulgated a regulation that reaches beyond even respondent's broad explanation of congressional intent. Accordingly, the regulation is not a reasonable interpretation of the statute and is invalid.

2. The inequities.

The example in *Western National* can be modified slightly to show the inequities that result from the mechanical test of the regulation. Using the same four claims from the same line of business and accident year but estimated at $1,000 each, rather than $500, at December 31, 1985, assume that two of the claims were paid for $750 each during 1986 and the other two claims remained in loss reserves at $1,000 each at December 31, 1986. The mechanical test would produce reserve weakening of $500, *i.e.*, $2,000 of loss reserves at December 31, 1986 less the net of $4,000 of loss reserves at December 31, 1985 and $1,500 of payments in 1986, equals ($500). This insurer was overreserved at December 31, 1985 in contrast to the insurer discussed above which was underreserved. The overreserved insurer could increase loss reserves for another line of business and accident year, and its "fresh start," by an aggregate of $500 as of December 31, 1986 without fear of "reserve strengthening" under the mechanical test.

Thus, the mechanical test penalizes underreserved insurers which have claimed, as a result of the underreserving, lesser amounts of deductions in 1986 and

prior years than they were entitled to claim. At the same time, insurers which were overreserved at December 31, 1985, within limits allowed under applicable law, not only would be deemed to have weakened loss reserves, but would be able to increase loss reserves and the "fresh start" without fear of any penalty for "reserve strengthening." One of petitioner's experts, James MacGinnitie, provides additional examples of the inequities that arise out of the mechanical test for "reserve strengthening." (Jt. App. at 107-08.)

The above examples demonstrate that the mechanical test in the regulation would not capture some loss reserve increases and captures amounts that are not loss reserve increases simply as a result of the vagaries of an insurer's prior reserving practices. A regulation that confers an extra benefit on one insurer, and an extra burden on another (even though it did not adjust loss reserves, except for adjustments that resulted from claims payments), clearly is not a reasonable interpretation of the statute and is invalid.

CONCLUSION

For the reasons set forth above, the Court should reverse the judgment of the Court of Appeals for the Third Circuit and reinstate the judgment of the Tax Court.

Respectfully submitted,

George R. Abramowitz
Counsel of Record
Dennis L. Allen
M. Kristan Rizzolo
LeBoeuf, Lamb, Greene & MacRae, L.L.P.
1875 Connecticut Avenue, N.W.
Washington, D.C. 20009-5728
(202) 986-8000
John S. Breckinridge, Jr.
James H. Kenworthy
LeBoeuf, Lamb, Greene & MacRae, L.L.P.
125 West 55th Street
New York, New York 10019
(212) 424-8000

Counsel for Petitioner